

**STATE OF CALIFORNIA  
DEPARTMENT OF INSURANCE  
45 Fremont Street, 24th Floor  
San Francisco, California 94105**

**INITIAL STATEMENT OF REASONS**

**RH-04041191  
August 23, 2005**

**MINIMUM RESERVE STANDARDS FOR VALUATION OF  
DISABILITY INSURANCE CONTRACTS**

**INTRODUCTION**

California Insurance Commissioner John Garamendi ("Commissioner") proposes the adoption of amendments to the California Code of Regulations ("CCR"), Title 10, Chapter 5, Subchapter 3, Article 3.5 entitled "Minimum Reserve Standards for Valuation of Disability Insurance Contracts," sections 2312 (Claim Reserves), 2312.5 (Contract Reserves), and 2315 (Specific Standards for Morbidity, Interest, and Mortality). The Commissioner proposes the adoption of amendments to these sections pursuant to the authority vested in him by sections 997(a) and 10489.95 of the California Insurance Code. The Commissioner's decision on the proposed amendments will implement, interpret, and make specific the provisions of Insurance Code section 985, 997, and 10489.15(a).

Existing sections 2312, 2312.5, and 2315 are based on the National Association of Insurance Commissioners' ("NAIC") Health Insurance Reserves Model Regulation (NAIC Model No. 10). Sections 2312, 2312.5, and 2315 all became operative on December 5, 1994. Since that time the NAIC has revised its Health Insurance Reserves Model Regulation. The Commissioner has determined that it is necessary to conform California's existing regulations section 2312, 2312.5, and 2315 to the revised NAIC Model. Except for certain instances such as changes in grammar, format, numbering, citation, or correction of typographical errors, the Commissioner's proposed changes to sections 2312, 2312.5, and 2315 follow the language of the revised NAIC Model Regulation.

**DESCRIPTION OF THE PUBLIC PROBLEM**

Each year life and disability insurers are required by law to prepare and file an annual statement which, among other things, discloses financial information about the company which the Department of Insurance reviews to ensure that the company is operating in accordance with applicable laws. Each annual statement contains information on the sufficiency of the insurer's reserves to cover future obligations, such as claims. Existing law (CCR sections 2312, 2312.5, and 2315) prescribes how reserves must be calculated and maintained, and what levels of reserves are required by law. All three of these sections are derived from the NAIC's Health

## Insurance Reserves Model Regulation (NAIC Model 10).

The Commissioner now proposes to amend sections 2312, 2312.5, and 2315. By and large the amendments are identical to or closely parallel recent revisions made by the NAIC to the NAIC Model Regulation upon which sections 2312, 2312.5, and 2315 were originally based. The actuarial bases (such as mortality, morbidity) for valuation of policies under the NAIC Model Regulation and also the Department of Insurance's own minimum reserve standards regulations must be updated from time to time to reflect changing conditions and more recent data. The proposed amendments are necessary to achieve this objective.

In addition to the obvious benefits of using more recent data as opposed to older data, the proposed amendments are necessary to promote uniformity of standards among different states. The current revisions to the NAIC model regulation are in the process of being adopted by several different states. Both insurers and consumers benefit when administrative costs related to compliance with multiple, inconsistent regulatory requirements imposed by different states are reduced. The purpose of the proposed amended regulations is to ensure that California's regulatory requirements in this area are as consistent with those of other states as is possible under California law. Everyone stands to benefit when insurers, operating in compliance with California law, are able to devote additional resources -- resources which would otherwise be expended satisfying multiple, inconsistent regulatory regimes -- to improving their financial stability or providing better products to consumers. The proposed regulations are reasonably necessary to the degree to which they help to achieve this goal.

The proposed amendments to sections 2312, 2312.5, and 2315 implement, interpret, and make specific the reserving requirements of Insurance Code sections 985, 997, and 10489.15(a) by specifying and clarifying the way in which the minimum reserves shall be calculated and maintained. The overall objective is to facilitate enforcement of the statutory minimum reserving requirements in a manner that is also consistent with the NAIC standards and with the NAIC standards as adopted by other states.

### SPECIFIC PURPOSE AND REASONABLE NECESSITY FOR REGULATIONS:

The specific purpose of each regulation and the rationale for the Commissioner's determination that each regulation is reasonably necessary to carry out the purpose for which it is proposed is set forth below.

Section 2310 of the Department of Insurance's existing regulations requires that the adequacy of an insurer's reserves be determined on the basis of three separate categories of reserves: claim reserves, contract reserves, and premium reserves. The actuarial bases (e.g., mortality and morbidity bases) for the first two categories are being updated in the proposed regulations to more accurately reflect current conditions and recent data. In addition, the proposed regulations expand upon existing regulations to clarify existing and new requirements, and to promote consistency with the NAIC Model Regulation and the regulations of other states to the extent that they too adopt regulations based on the NAIC Model.

## Section 2312. Claim Reserves.

The purpose of section 2312 is to set forth general rules governing the minimum reserves that insurers must maintain to cover all incurred but unpaid claims (including claims accrued and unaccrued, reported and unreported). The standards established by this section are necessary to ensure that insurers have enough money in their reserves to pay claims, and that insurers are subject to uniform reserving standards.

The proposed amendments to section 2312 update the section by incorporating recent amendments to the NAIC Health Insurance Reserves Model Regulation (NAIC Model 10). Existing law does not contain the NAIC updates.

The language in section 2312 (b)(1)(B) 1. and 2. allows insurers to continue using their current morbidity standards for disability income claims that have already occurred. It also gives the insurers the option of calculating reserves for individual and group disability income claims incurred on or after January 1, 2005 according to morbidity standards that are based on other acceptable experience. The language of this section has been amended to conform to the language of the NAIC Model Regulation, but the requirements are essentially unchanged. This amendment promotes uniformity with the NAIC standards.

The capital letters in subsections of Section 2312(b)(1)(B)2.(ii) have been changed to Roman numerals. This change is necessary to conform the amended regulation to an organized outline format.

Section 2312(b)(1)(B)3. (including parts (i) and (ii)) gives insurers a choice of morbidity standards for disability income claims incurred prior to January 1, 2005. The insurer may choose to calculate its claim reserves using the minimum morbidity standard in effect as of the date the claim was incurred, or it may choose to use the minimum morbidity standards set forth in section 2312(b)(1)(B)1. and 2. Once the insurer elects to calculate reserves as defined in 1. and 2., all future valuations must be on that basis to promote consistency.

Existing section 2312(c) does not state whether approximations of claims data based on groupings or averages may be used. Sometimes insurers do not have sufficient data for the required calculations unless they use groupings and averages. The amendment to section 2312(c) clarifies the standard by stating that the insurer may use approximations based on groupings and averages. The amendments to section 2312(c) also change the word “employed” to “valued” because “valued” more accurately describes what is done with the reserve data.

Except for the re-numbering of paragraphs, which is a non-substantive change, all of the proposed amendments to section 2312 are necessary to update the section by incorporating provisions from the current version of the NAIC Model Regulation.

## Section 2312.5. Contract Reserves.

The purpose of current section 2312.5 is to regulate contract reserves, which are reserves for claims which may occur in the future. Section 2312.5 states when contract reserves are required and how contract reserves must be calculated. The proposed amendments to section 2312.5 are necessary to clarify and expand the regulation so that it is consistent with the NAIC Model Regulation. These provisions are also necessary to foster more accurate reserving. Existing law does not set forth the new requirements.

The language added to section 2312.5(a)(1)(B) allows insurers to use data collected on a block basis (as opposed to data maintained on an individual basis for each insured) if the premiums are developed on a block basis to support risk assumed and expected expenses for the block. The rationale is that if the insurer develops premiums on a block basis, then it makes sense and is consistent to allow the insurer to maintain reserves on a block basis. The new language requires an actuary to certify that the premium development was on a block basis. The certification helps to ensure compliance with this section. The language of the proposed amendment to section 2312.5(a)(1)(B) is taken directly from the NAIC Model Regulation, with one exception: for clarity, the Department of Insurance expanded the citation at the end of the paragraph from a partial citation, “subsection (b),” to a complete citation: “subsection 2312.5(b).”

The new language set forth as section 2312.5(a)(5) is taken directly from the NAIC Model Regulation. It provides that the insurer’s contract reserve shall incorporate provisions for moderately adverse deviations. This requirement is consistent with recent changes in the Department of Insurance’s Actuarial Opinion and Memorandum Regulations (California Code of Regulations Title 10, Chapter 5, Subchapter 3, Article 17, section 2580.1 et seq.), which require adequacy of reserves to be justified on moderately adverse deviations.

The number (1), the heading “Basis,” and the substitution of (A) for (1) have been added to organize and clarify the provisions of section 2312.5(b) as amended to incorporate provisions of the NAIC Model Regulation. This change is necessary to conform the amended regulation to an organized outline format.

The new language added to section 2312.5(b)(1)(A) concerning morbidity tables is from the NAIC Model Regulation: “The morbidity tables shall contain a pattern of incurred claims cost that reflects the underlying morbidity and shall not be constructed for the primary purpose of minimizing reserves.” This means that insurers may not reduce morbidity levels simply to justify a reduction in reserves for contracts for which tabular rates are not specified in section 2315. This requirement is necessary to ensure that reserves are not reduced to inappropriately low levels.

The current version of section 2312.5(b)(1)(A) contains a typo which is corrected in the proposed regulations by striking “or” on line four of the first paragraph and inserting the word “of” in its place

Section 2312.5(b)(1)(A)1 and 2312.5(b)(1)(A)2 consist of new language taken from the NAIC Model Regulation. These new paragraphs are necessary to give actuaries some guidance on implementing the requirements of section 2312.5(b)(1)(A) as amended.

Section 2312.5(b)(1)(A)1 has been added to allow morbidity assumptions to be the best estimate of anticipated future experience, but not to incorporate any expectations of future morbidity improvement. However, the last sentence of paragraph 1 is intended to provide allowances for a known event, such as a new drug release that would significantly affect morbidity assumptions, even though at this time there are no specific examples that could be noted in the recent past that would have met this standard. This is intended to be an extremely rare event.

Section 2312.5(b)(1)(A)2., taken from the NAIC Model Regulation, provides insurers with a limited exception to the requirements of section 2312.5(b)(1)(A)1. Section 2312.5(b)(1)(A)2. provides that insurers which have reserve bases that do not meet the requirements of section 2312.5(b)(1)(A)1. and which have business in force as of the effective date of the regulations may continue using their existing reserve bases if they convince the Commissioner that continued use of the reserve bases is acceptable.

Section 2312.5(b)(1)(C)2 is language taken from the NAIC Model Regulation. It has been added as an amendment to section 2312.5 because there is a need for uniform actuarial standards applicable to long term care contract reserves. The new language means that contract reserves for long term care individual policies or group certificates issued on or after January 1, 2005 will be determined using the updated mortality data set forth in the amended section 2315 rather than older data that would be less accurate for recent claims. The remainder of this subsection sets forth standards for contract reserves for terminations other than mortality.

2312.5(b)(4) is language taken from the NAIC Model Regulation. It states that the contract reserve on a policy basis for long term care insurance shall not be less than the net single premium for nonforfeiture benefits at the appropriate policy duration, where net single premium is computed according to the proposed regulations. This proposed regulation promotes solvency by establishing a minimum amount that each insurer must maintain as a contract reserve for long term care policies, which is never less than the nonforfeiture cash surrender value, if the policy has nonforfeiture benefits.

The remaining changes to this section consist of corrections to typographic errors and renumbering of paragraphs. These changes are necessary so that new language from the NAIC Model Regulation fits into the outline format of the existing section 2312.5.

#### Section 2315. Specific Standards for Morbidity, Interest, and Mortality.

From time to time, in light of new experience, standards for morbidity, mortality, termination rates, and other data are updated after investigations by entities such as the Society of Actuaries generate newer, and thus more accurate or relevant data. California Insurance Code section 997(a) authorizes the Commissioner to regularly incorporate updated data into California law.

The NAIC Model Regulations contain updated, specific minimum morbidity standards and termination assumptions, along with explanations on how the new data should be used in determining reserves. The purpose of section 2315 is to establish uniform standards for morbidity, interest, and mortality. Section 2315 of the proposed regulations, as amended, now contains the updated standards for morbidity and mortality, along with explanations on how the standards should be used. Section 2315 as amended also contains the updated mortality standards for long-term care policies. Existing law does not contain the updated standards or explanations on how they should be used, and does not create special, more precise provisions for long-term care policies. The amendments to section 2315 are necessary to incorporate updated, more uniform standards, explanations on their use, and provisions that are specifically tailored to long-term care policies into the regulations.

Specifically, Section 2315(a)(1)(A)2.(i) sets forth a table of adjustment factors and adjusted termination rates for individual disability claims incurred on or after January 1, 2005. This section also explains the derivation of the tables and sets forth instructions on how they should be used. Section 2315(a)(1)(A)2.(ii) gives insurers some flexibility for older claims by providing that for claims incurred prior to January 1, 2005 the insurer may choose to perform its calculations using either the minimum morbidity standard in effect for contract reserves on currently issued contracts as of the date the claim is incurred, or the new standard set forth in section 2315(a)(1)(A)2.(i). Section 2315(a)(1)(A)2.(ii)(III) provides that once an insurer chooses a morbidity standard to use for its reserve calculations all future valuations must be on that basis. In other words, the insurer may not switch back and forth between one standard and the other – once it has chosen a standard it must continue using the chosen standard for those particular reserve calculations. This is consistent with the proposed language in subsections 2312(b)(1)(B)3.(i) and (ii). This restriction is necessary to promote consistency and reduce manipulation of data.

Section 2315(c) allows insurers to determine the mortality basis for all policies except long-term care individual and group policies issued on or after January 1, 2005 by reference to tables permitted by Insurance Code section 10489.2(a). The proposed regulation as amended allows them to determine the mortality basis for long-term care individual or group policies issued on or after January 1, 2005 by reference to the 1994 Group Annuity Mortality Static Table. These amendments permit the use of the updated mortality standards for long-term care policies.

The remaining changes to section 2315 simply renumber paragraphs so that new language can be incorporated into the format of the existing regulation.

#### SPECIFIC TECHNOLOGIES OR EQUIPMENT

Adoption of these regulations would not mandate the use of specific technologies or equipment.

#### IDENTIFICATION OF STUDIES

There are no technical, theoretical, and empirical studies, or similar documents relied upon in proposing the adoption of the regulations. The Commissioner has relied upon the NAIC's

Health Insurance Reserves Model Regulation (NAIC Model 10) in proposing adoption of the regulations.

#### REASONABLE ALTERNATIVES TO THE REGULATIONS; IMPACT ON SMALL BUSINESS

The Commissioner has identified no reasonable alternatives to the presently proposed regulations, nor have any such alternatives otherwise been identified and brought to the attention of the Department of Insurance, that would carry out the purpose for which the regulations are proposed or which would lessen any impact on small business. Indeed, the proposed regulations are not anticipated to affect small business. Although performance standards were considered as an alternative, they were rejected as ineffective in addressing the problem of updating minimum reserve standards and promoting uniform regulation of reserve standards among various states and the NAIC.

#### ECONOMIC IMPACT ON BUSINESSES AND THE ABILITY OF CALIFORNIA BUSINESSES TO COMPETE:

The Commissioner has made an initial determination that the proposed regulations may have a significant, statewide adverse economic impact directly affecting business, including the ability of California businesses to compete with businesses in other states. The types of businesses that may be affected are insurance companies. Insurance companies may incur some costs as a result of updating the way they calculate reserves. The Commissioner has considered performance standards, but the Commissioner has identified no performance standards that would be as effective as the proposed regulations in enforcing the statutes that form the basis for the proposed regulations. The Commissioner has not considered other proposed alternatives that would lessen any adverse economic impact on business and invites interested parties to submit proposals. Submissions may include the following considerations:

- (i) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to businesses;
- (ii) Consolidation or simplification of compliance or reporting requirements for businesses;
- (iii) The use of performance standards rather than prescriptive standards;
- (iv) Exemption or partial exemption from the regulatory requirements for businesses.

#### PRENOTICE DISCUSSIONS

The Commissioner conducted a prenotice public discussion of the proposed regulations pursuant to Government Code section 11346.45 on March 30, 2005. Notice of the prenotice public discussion was provided to all those who have requested notice of regulatory proceedings conducted by the Commissioner concerning the subject matter of the regulations. The Commissioner received written and oral comments from one interested party before the March 30, 2005 public discussion, but no one attended the March 30, 2005 public discussion, and no other comments were received. The one individual's comments have been reviewed and considered in drafting the proposed regulations.

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